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Between Dependency and Globalisation

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Abstract

This paper offers a first assessment of the contribution of international production to the dynamics of regional integration in Europe. After very high expectations, there is increasing scepticism concerning the role of foreign direct investment as an engine of growth in the region. On the basis of often implicit cross regional comparisons, it is argued that the level of foreign direct investment in Central and Eastern Europe (CEE) is low, that it does not lead to significant technology transfers and backward linkages, and that the prospects for 'Cross national productions networks' to develop continent-wide are at best uncertain.

The paper argues that generalisations based on foreign direct investment figures hide more than reveal and looks at the development of Outward Processing Traffic between the European Union (EU) and CEE as an alternative source of evidence to characterise some of the transformations that the European model of integration is undergoing.

It finds that EU firms, mainly medium sized German companies, make an important use of non equity forms of international production when expanding eastwards. The resulting patterns of cooperation are 'fluid', but not necessarily precarious. In fact, they are an ideal vehicle for implementing new flexible methods of production which have greater potentials for spillovers and 'multiplier effects'. Overall, these patterns of cooperation give rise to different market linkages that hardly fit into static categories, a process in which policy makers have only little say.

Zusammenfassung

Die vorliegende Studie bietet eine erste Bewertung der Auswirkungen internationaler Produktion auf die Dynamik regionaler Integration in Europa. Was die Rolle ausländischer Direktinvestitionen angeht, so sind die anfänglich sehr hohen Erwartungen mittlerweile der Skepsis gewichen. Auf der Grundlage oftmals impliziter regionsübergreifender Vergleiche wird hier festgestellt, daß Direktinvestitionen in Zentral- und Osteuropa niedrig sind, daß sie keine nennenswerten Technologietransfers und „backward linkages“ mit sich bringen, und daß die Aussichten für die europaweite Entwicklung „transnationaler Produktionsnetzwerke“ bestenfalls unsicher sind.

Es wird argumentiert, daß Verallgemeinerungen auf der Basis von Direktinvestitionsziffern mehr verschleiern als enthüllen. Daher wird hier die Entwicklung von „Outward-Processing-Verkehr“ zwischen der Europäischen Union und Zentral- und Osteuropa als alternative Quelle herangezogen, um einige der Transformationen zu kennzeichnen, welche das europäische Integrationsmodell im Augenblick durchmacht.

Eine Feststellung ist, daß EU-Firmen, insbesondere mittelständische deutsche Unternehmen, bei der Ausdehnung in Richtung Osten starken Gebrauch von internationalen Produktionsnetzen zwischen unabhängigen Firmen (non-equity forms of production) machen. Die daraus resultierenden Kooperationsmuster sind „fließend", aber nicht unbedingt unsicher. Sie könnten sich im Gegenteil als ideales Vehikel für die Einführung neuer flexibler Produktionsmethoden erweisen, die größeres Potential für Spillovers und Multiplikationseffekte bieten. Insgesamt führen solche Produktionsnetze zwischen unabhängigen Unternehmen zu neuen Marktverbindungen, die sich kaum in feststehende Kategorien einordnen lassen. Auf diesen Prozeß haben Politiker nur wenig Einfluß.

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1. Introduction

By making suddenly permeable the frontier between two areas at different levels of development, the fall of the Berlin wall has released a formidable potential for growth and competitiveness in Europe. The opening up of Central and Eastern European (CEE) markets represents an unprecedented opportunity for companies from the European Union (EU) to relocate their activities Eastwards, while making it possible for CEE firms to access Western markets, capital and technology.

Concern and the first disillusions followed the high expectations placed on such a process. If the danger of an outburst of CEE imports of cheap labour-intensive ‘sensitive’ goods was quickly dismissed (Rollo and Smith 1993), some still argue, on the basis of low foreign direct investment figures, that integration is and will remain 'shallow', limited to the sphere of exchange (Martin 1998). Others acknowledge that some internationalisation of production is taking place in CEE but highlight the risk that foreign direct investment promote the development of ‘enclaves’ without bringing about technology transfer and backward linkages (Katzenstein 1997). Worse perhaps, some observers fear the 'maquiladorisation' of CEE, and warn against the possible structural dependency of a peripheral Europe on a developed Western core (Ellingstad 1997). Overall, a scenario of 'globalisation' where 'International Production Networks' spearhead a regional dynamics of integration on the Asian model has not, for the time being, materialised (Zysman and Schwartz 1998).

This paper argues that the contribution of international production to local development and to the dynamics of regional integration is not as disappointing as often suggested. In fact, the impact of international production is inadequately assessed if the focus is solely placed on foreign direct investment. An important feature characterising the European model of integration is indeed, the use EU firms (mainly of German origin) make of non-equity forms of international production to implement new flexible methods of production. As a result, a ‘fine division of labour’ is under way in the region which hardly compares with other regional experiences (Zysman et al. 1996).

To make this point, the paper looks at Outward Processing Traffic (OPT) between the EU and CEE. OPT trade data trace the temporary export of material sent for processing by EU firms to CEE, and their re-import undertaken under a preferential trade regime granted by the EU. First, the quantitative importance of OPT shows that production is indeed being internationalised in CEE and that non-equity forms of production play an important role in this process. Low foreign direct investment statistics therefore, hide more than they reveal simply because they do not take into account non-equity relations which is precisely what OPT data do.

Second, far from reflecting a single thrust of dynamics of regional integration, the OPT developments foster a large array of inter-firm relations which depend on the country, the sector and the size of the firms concerned. Hence, the arrangement which was originally designed by EU policy makers to lock local firms into production chains controlled by EU firms is, in certain cases, used by German firms to implement new production methods. The resulting patterns of co-operation have the double merit of solving specific problems confronting German firms in their home political economy and of being a major source of spillovers to local economies.

Section Two explains the way in which policy makers intend to shape the terms of East-West economic interdependence by adopting the OPT measure. Section Three explores the actual patterns of OPT and highlights its quantitative importance. The two following sections undertake a more qualitative analysis: whereas Section Four identifies different patterns of evolution, Section Five puts forward some explanatory factors. A concluding section proposes some reflections on the grip policy makers have in the definition of the terms under which economic interdependence develops between Western and Eastern Europe.

2. The OPT Mechanisms

Free trade is rarely established at once, and the very process of trade liberalisation is far from being neutral. The OPT case shows that trade arrangements left in place during the transition toward free trade can have important implications for the terms under which economic interdependence develops between two area. This section reviews the OPT mechanisms and the distortions thus introduced by policy makers before showing the wider relevance that the OPT evidence has for understanding how the division of labour in an enlarged Europe takes place.

The raison d'être of OPT is to ease trade restriction measures imposed at the EU border on the 're-imports' after processing of material which originates in the EU.[1] If an EU producer sends material to be processed in one of the Associated country, it can re-import the material under a preferential trade treatment, i.e., without facing the restrictions which pertain to normal ('direct') imports into the EU. The preferential treatment consists in granting additional specific OPT quota in sectors protected by quantitative restrictions (mainly Textile and clothing), and in removing tariff protection in the other sectors.

[1] The two basic legislative texts currently enforced are contained in the EC Customs Codes (OJ L 302, 19.10.92) and Council Regulation 3036/94 of 8 December 1994 (OJ L 322, 15.12.94).

This measure has a direct influence on the patterns of East-West economic interdependence. It first introduces a geographical bias favouring transactions between the EU and CEE to the detriment of exchanges with third trading partners.[2]

The OPT measure also influences the type of market linkages developing between the EU and CEE. By granting preferential access to *re*-exports, the OPT measure promotes the relocation of EU firms' activities through contractual non-equity links as opposed to the development of foreign direct investment and 'independent' exports (Corado 1995).

Finally the OPT mechanisms have an impact on the volume of the transactions involved. The fact that it is foreign partners who source the inputs and that it is again them who market the output makes the arrangement particularly attractive to foreign partners, but also, paradoxically to local firms. While OPT enables EU firms to reorganise their international production activities in CEE without incurring any substantial 'exit costs', local partners might consider OPT to be a good second best option even if they lose control over the two extremes of the production chain. By easing trade restrictions, OPT is crucial for competitive local firms which come against EU trade protection. In addition, the arrangement gives free access to good quality input, a prerequisite to international competitiveness, which makes possible the process of restructuring in a general context of capital shortage. Finally, OPT helps penetrate distribution networks abroad, and it is in principle an ideal channel for technology transfers, and other 'spillovers' of know-how. From both the perspective of foreign and local firms, therefore, the incentives to resort to the arrangement are high.

Overall, the mechanisms of the OPT measure tie CEE firms into vertical production chains controlled by EU firms and promote the vertical division of labour at the regional scale. It is worth stressing that OPT forces CEE firms into co-operation with EU partners, especially where the former present a competitive threat to Western interests, i.e., when trade restrictions on their direct exports to the EU are binding. Hence, OPT is not only an instrument facilitating CEE trade reorientation; it also contributes to the transformation of potentially 'rival' patterns of trade and production specialisation into complementary ones (Zysman et al. 1996).

[2] The Associated countries of Central / Eastern Europe benefit from a particularly favourable treatment as tariffs are entirely removed. By contrast, the OPT measure, when it applies to other trading partners, provides only for a partial suspension of tariff restrictions.

3. OPT Patterns

The OPT measure adopted at the Community level introduces so to speak *de jure* bias, which discriminate between EU and CEE firms and between the different vehicles they have at their disposal for organising international production in CEE. But what firms from different countries and sectors make of the arrangement is in fact a slightly different story. Two features stand out. First, the importance of OPT as a vehicle of interdependence between Central/Eastern and Western Europe, and second the overwhelming domination of the OPT business by German firms.

The first characteristic of OPT, its quantitative importance in East-West transactions, is illustrated by a series of different indicators both in static and in dynamic terms.[3]

In aggregate terms, OPT represents around 13% of the total exports of CEE to the EU in 1996, after having reached a peak of 17% in 1993. Approximately half of EU OPT is geared to Poland, whereas both the Czech Republic and Hungary account for around 20% of EU OPT to the CEE. In last position, Slovakia attracts less than 10% of EU OPT. Poland is a privileged destination for OPT in textile and clothing, and it is almost the unique location of EU OPT in furniture. The Czech Republic and Hungary, instead, attract comparatively more OPT in the electrical and mechanical machinery industries.

Table 1

Distribution of EU OPT re-imports after processing from the CEE4 (%), and absolute level (ECU 100 Million), 1996.

	Germany	Austria	Italy	Netherl.	Denmark	France	EU15
Poland	44.9%	0.9%	13.8%	64.3%	94.7%	45.5%	43.3%
Hungary	18.6%	68.8%	55.2%	21.4%	2.1%	36.4%	25.6%
Czech R.	30.4%	18.8%	6.9%	3.6%	0.5%	9.1%	23.5%
Slovakia	6.1%	12.5%	20.7%	10.7%		9.1%	7.6%
CEC4	29.6	3.2	2.9	2.8	1.9	1.1	43.4

3 All the data contained in the present and subsequent sections come from EUROSTAT's COMEXT database. An important caveat is to be made concerning the significance of OPT statistics. As trade barriers fall, the advantages associated with the arrangement are reduced, and so is the incentive to declare temporary trade flows as such. Tariff barriers and quantitative restrictions were suspended as of January 1st, 1995 and January 1st, 1998, respectively. The year 1996 has therefore been chosen as a compromise in order to minimise this 'statistical' effect. On the implications of the fact that OPT data do not account for relocation activities which are not associated with a double trade flow, see Schmidt, and Naujok (1994).

At the beginning of the transition period, Hungary used to be the most dependent on OPT (owing 20% of its exports to the EU to OPT in 1992 and 1993). However, in 1996, the share of OPT in total exports to the EU was reduced to less than 13%. Poland took over the 1st position for OPT dependence as of 1994 and in 1996 16% of its exports to the EU is in fact OPT re-exports. As to the former Czechoslovakia, it started with the lowest levels of OPT, but following very dynamic trends, it reached 11% of its exports to the EU.

OPT develops in a well-determined set of sectors. Textile and clothing is the first concerned with approximately 3 Billion ECU involved in the business in 1996. Then, far behind, comes the sector of electrical machinery (ECU 600 Million in 1996), followed by a handful of sectors where the amount of OPT transactions is comprised between 100 and 200 Million ECU: mechanical machinery, furniture, and footwear.[4]

Some sectors in CEE are particularly dependent on the arrangement. This is obviously the case of the Textile and clothing sector which distinguishes itself by outstanding rates of dependence on OPT in all the CEE, and especially in Poland. Thus, more than 80% of total Polish exports of textile and clothing to the EU is undertaken under the OPT arrangement compared to around 73% of total Hungarian exports to the EU and only 50% of Czech EU exports. Other sectors characterised by high rates of dependence on OPT are the Czech and to a lower extent the Hungarian electrical machinery sectors (respectively 23%, and 14%). The Czech and Hungarian footwear sectors are also still significantly dependent on OPT(20 to 25% of total exports). Finally, critically OPT-dependent but involving much lower absolute levels of transactions are many Czech sectors like confectionery, printing, clocks, optical instruments etc ...

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4 There is a third category of sectors concerned by OPT which is not included in the present tables. By decreasing importance: plastics, car parts, food processing, leather, optical instruments, the printing industry, glassware, toys, base metal, iron and steel, where OPT absolute levels range between 10 and 80 M ECU. For more details see Pellegrin (1997).

Table 2

Proportion of OPT re-imports after processing in total EU imports from the CEE4 (%), and absolute levels (ECU 100 Million). In 1996.

	Germany	Austria	Italy	Netherl.	Denmark	France	EU15
All products							
Poland	21.1%	1.0%	4.1%	22.2%	33.2%	5.9%	*18.8*
Czech R.	15.2%	5.9%	3.8%	4.6%	1.1%	3.0%	*10.2*
Slovakia	10.4%	7.5%	13.5%	22.1%	2.4%	2.9%	*3.3*
Hungary	13.6%	15.5%	16.7%	16.9%	7.8%	8.3%	*11.1*
CEC4	*29.6*	*3.2*	*2.9*	*2.8*	*1.9*	*1.1*	*43.4*
Textile and Clothing							
Poland	86.1%	40.4%	58.0%	89.4%	93.5%	52.6%	*15.3*
Czech R.	63.3%	49.1%	17.1%				*4.3*
Slovakia	67.2%	60.3%	54.3%	80.7%			*2.5*
Hungary	79.4%	83.8%	75.6%	50.7%		58.9%	*7.1*
CEC4	*18.5*	*1.7*	*2.0*	*2.7*	*1.7*	*1.3*	*29.1*
Electrical machinery							
Poland	18.8%			6.5%		-	*1.0*
Czech R.	26.9%	23.4%		29.2%			*2.4*
Slovakia	11.8%	21.6%					*0.3*
Hungary	14.4%	21.0%		25.8%			*2.2*
CEC4	*4.2*	*1.0*		*0.2*		*0.2*	*5.9*
Mechanical machinery							
Poland	4.6%						*0.2*
Czech R.	11.2%						*0.8*
Slovakia	11.3%						*0.1*
Hungary	3.9%		8.9%				*0.4*
CEC4	*1.4*		*0.1*				*1.6*
Furniture							
Poland	14.3%						
CEC4	*1.5*						*1.6*
Footwear							
Poland	9.9%		18.9%		89.1%		*0.2*
Czech R.	30.0%		27.8%				*0.2*
Slovakia	1.1%		17.7%				*0.1*
Hungary	27.1%		31.1%				*0.6*
CEC4	*0.6*		*0.4*		*0.1*		*1.1*

The contribution of OPT to CEEs' trade performance is particularly clear in dynamic terms. Indeed, the arrangement has been one important factor contributing to the reorientation of CEE trade towards Western markets: between 1991 and 1996, the arrangement is responsible for 14% of the growth of CEE exports to the EU.[5]

[5] Between 1991 and 1996, OPT accounts for 20%, 13% and 7% of the growth of Polish, Czechoslovak, and Hungarian exports to the EU, respectively. However, if the reference period is

It is no coincidence that OPT is important precisely in the sectors which have been driving the export performances of CEE. Hence the sectors mentioned above, i.e., textile and clothing in the three countries, but more markedly in Poland, electrical and mechanical machineries in both the former Czechoslovakia and Hungary, and the furniture industry in Poland are all important sectors contributing critically to the overall trade performance of the CEE with the EU which, in turn, owe a large part of their dynamism to OPT. In the textile and clothing industry, for example, OPT explains between 70% (in the former Czechoslovakia) and 90% (in Poland) of the growth of exports to the EU.[6] It is also true, albeit with lower figures for sectors such as electrical machinery in the former Czechoslovakia and in Hungary, and for furniture in Poland where OPT contribution ranges between 10 and 20%.

The second important characteristic of OPT in CEE is the importance of Germany as a source of OPT transactions. Favoured by a very liberal interpretation of the Community legislation by the German authorities[7], German firms are responsible for approximately 70% of total EU OPT in the CEE in 1996 (i.e., around 3 Billion ECU). It is not only CEE firms which are dependent on OPT with German partners, but Germany's foreign trade with CEE is also significantly marked by the arrangement: the proportion of OPT in total German 'normal' trade with CEE represents 16% of total German imports from CEE in 1996.

Firms from other EU countries are not completely absent from the picture, however. Austrian, Italian, and Dutch firms are responsible for transactions amounting to around 300 Million ECU respectively (which is still 10 times less than the German OPT activities). Firms from Denmark and France follow with negligible amounts, while firms from other member states like the United Kingdom are conspicuous for their absence in the business.

Italian firms are extremely dynamic newcomers; they have privileged OPT relations with Hungarian partners which develop mainly in textile and clothing, in the footwear sector as well as in the plastic industry. In a way, the strong Italian attraction for Hungary substitutes for the diminishing German interest in the country. The other firms are much more specialised. Austrian firms, for example, undertakes OPT in the Hungarian textile and clothing and electrical machinery sectors, whereas Dutch firms are mainly present in the Polish textile and clothing and food processing sectors, and in the Czech electrical machinery industry. As to the OPT relations of

1991-1994, the corresponding figures are 29%, 17%, and 15% for Poland, the former Czechoslovakia, and Hungary, respectively. The formula used is the following: (OPT96 - OPT91) / (tot96 - tot91).

6 The above formula applies to OPT in sector i: (OPTi96 - OPTi91) / (toti96 - toti91). It gives the contribution of OPT in sector i to the exports of sector i.

7 Until 1993, member states were responsible for the provision of quantitative restrictions in general, and OPT quota in particular. What is more, because of the considerable amount of controversy raised by the formulation of an OPT policy at the Community level, the EU legislation contains many obscure provisions that member states can interprete according to their own policy priorities.

Danish firms, they take place overwhelmingly, if not exclusively, with Polish partners in textile and clothing. Finally, French operators illustrate themselves by being among the few to disengage from the business in absolute terms.

Overall, OPT appears to be a privileged vehicles of interdependence between the EU and CEE, not only from the viewpoint of CEE firms, but also for EU firms in general, and for German firms in particular. The objective of EU policy makers to promote the extension of EU production networks in CEE seems thus successful. But the fact that it is actually German firms which turned the arrangement to their advantage comes as an important amendment to this general objective: CEE firms are in fact integrated into production chains controlled mostly by German firms. What does this tell us about the terms under which East-West economic interdependence develops?

4. OPT Evolution

With OPT, all the elements are apparently reunited to place the 'family silver' in foreign - German - hands (Martin 1998:9; Sinn and Weichenrieder 1997). If the arrangement proved to be a good second-best making possible trade reorientation to Western markets, it is not clear what its benefits for local firms are. Two sorts of risks are associated with the OPT type of co-operation.

The OPT measure is the European version of the American provision which gave way to the development of maquiladora in the Mexican US border region.[8] Records are mixed, but overall maquiladora have been accused to lock local firms into low value added activities, without giving them real chances for upgrading along the production chains of their partners. Maquiladora were also charged of keeping wages increases below productivity rise and of bringing about little backward linkages with other local Mexican firms (Ellingstad 1997).

At the opposite, another possible drawback of OPT is if wages are allowed to increase. Foreign partners who possibly engaged in the OPT business with the objective of exploiting low labour costs on the short-term, would then withdraw massively from their commitments, and severely damage local firms' access to inputs and markets.

The patterns of OPT evolution identified in Section 3 say something about whether these scenario actually materialise. Comparing OPT to direct and total trade shows that OPT follows different evolutions which correspond to different possible types of OPT partnerships at firm-level. Among the 'trajectories' of 'OPT networks'

8 Item 806.30 and 807.00 of the old US Tariff Schedule, and now HTS 9802.00.600 and 902.00.800.

(i.e., the partner countries and the sector in which OPT takes place) presented in Table 3, different categories appear. First, in a handful of cases, OPT follow absolute decreases (for example, in the footwear sector, between German firms on the one hand, and Hungarian and Polish partners, on the other hand). In the other cases, there are two possibilities: either OPT increases faster than direct trade (increasing proportion of OPT), or OPT increases are slower than the growth of direct trade (decreasing proportion of OPT).

Table 3

The evolution of 'OPT networks': growth of CEE re-exports after OPT to EU countries, and growth of OPT proportion in total exports, in %, 1991-1996.

OPT networks	evolution of OPT	evolution of OPT proportion
textile and clothing		
Germany-Poland	+117.3	+2.9
Germany-former CS	+304.5	+60.9
Germany-Hungary	+27. 2	+2.1
Netherl.-Poland	+255.0	+20.3
Italy-Hungary	+378.4	+92.8
France-Poland	+ 67.6	-3.4
France-Hungary	+31.1	-19.6
footwear		
Germany-former CS	+258.0	-12.6
Germany-Hungary	-60.8	-68.7
Germany-Poland	-71.0	-75.1
France- former CS	-88.9	-86.4
Italy-Hungary	+6776.0	+1306.5
electrical mach.		
Germany-former CS	+600.6	-37.2
Germany-Hungary	+81.1	-58.5
mechanic. mach.		
Germany-former CS	+81.7	-59.0
Germany-Hungary	+13.3	-71.0
Germany-Poland	-28.8	-61.5

Generally speaking, textile and clothing falls into the first category while the other networks tend to be characterised by a decreasing share of OPT in total trade. Some exceptions are noteworthy: Italo-Hungarian partnerships in the footwear and the plastic industries, as well as Germano-Czech partnerships in several minor sectors (the printing industry, leather, glassware...) are characterised by increases of OPT absolute levels and proportions.

A few stylised facts are particularly significant.

a. The dynamism of total trade performances in the OPT sectors

The trajectories of OPT belie, as a rule of thumbs, a scenario in which the trade performances of local firms are harmed by the sudden withdrawal of foreign partners. For a start, total trade is in general very dynamic in the sectors where OPT develops. In fact, in a majority of networks, OPT keeps on increasing. And even when OPT decreases, its negative contribution is more than offset by the performances of direct trade so that overall the trends of total trade remain positive. The cases where OPT actually harms overall export dynamism are relatively rare; they mainly occur in the food processing and in the footwear sectors.

Thus, there is no evidence of the destruction of local export capabilities resulting from the cessation of OPT activities due to wage increases. It is rather the opposite trend which is observed: OPT activities go hand in hand with the strengthening of trade performances.

b. Different cases of prolonged OPT partnerships

In the textile and clothing sector, each single OPT network is characterised by exponential OPT growth rates, irrelevant increases (if not decreasing trends) of direct trade, and resulting high and raising proportions of OPT in total trade (ranging between 60 and 80%). These trends suggest that foreign partners prolong their presence in the OPT business, and that this takes place at the expense of direct exports.

The trajectories of German OPT networks in the Czech and Hungarian electrical machinery sectors (as well as German OPT in the Polish furniture and in the Czech mechanical machinery sectors) also speak in favour of the permanence of foreign partners, but in a completely different fashion. They are all characterised by two traits: increasing OPT transactions, and, in contrast with the textile and clothing case, an outstanding growth of direct -untied- exports (especially in the former Czechoslovakia). As a result, OPT proportions in total exports to the EU decrease (faster in Hungary than in the former Czechoslovakia). However, OPT proportions still register the respectable figure of approximately 20%.

These trends are particularly striking because decreasing tariffs are less and less of an incentive to resort to OPT. The fact that OPT transactions remain high while direct trade follows extremely dynamic trends is quite encouraging. Indeed, it means that foreign partners are, under one form or another still present and that their prolonged presence is not detrimental to the development of independent exports; on the contrary, it possibly plays an active role in consolidating export performances.

c. The cessation of OPT partnerships in Hungary

An important country-specific feature concerns Hungary where OPT is mostly characterised by decreasing absolute and relative levels. Interestingly enough, such trends are also often accompanied by very dynamic trends of direct trade. Thus, in the sector of mechanical machinery, and in the automotive industry, for example, direct exports seem to 'take-over' decreasing OPT. This poses somewhat of a puzzle: why would 'local firms' be suddenly able to take over OPT production on their own (i.e., autonomously) while they were until now impeded to do so? In fact, it is sensible to consider that the excellent trade performances are due to the continuing presence of foreign partners who transform their relations with local firms. As a result, the presence of the former OPT partners is no longer statistically registered as such. In short, decreasing OPT and very strong rises of direct trade might well reflect the development of foreign direct investment following OPT partnerships.

The Hungarian pattern contrasts with that of the former Czechoslovakia and Poland. In the former country, OPT increases in width (many sectors involved) and depth (absolute increases of OPT transactions), whereas in the latter, it is increasingly concentrated in a few sectors (mainly textile and clothing and furniture).

d. The specific case of the footwear sector

The footwear industry is an excellent illustration of how contrasted the evolution of EU-CEE OPT relations can be. Two OPT networks are marked by increasing trends: Germano-Czech and Italo-Hungarian partnerships. Instead, Germano-Hungarian and Franco-Czech partnerships testify to the withdrawal of EU partners.

German OPT relations with Hungarian partners were traditionally one major source of OPT in the sector. Total trade flows in footwear between the two countries were also the most important. However, between 1991 and 1995, OPT decreased in the context of a drastic reduction of OPT proportions.

A radically contrasted evolution was registered in the case of Italian OPT in Hungary (and, with lower absolute levels involved, in Poland) and German OPT in the former Czechoslovakia where OPT increased strongly and much faster than direct trade. The facility with which the geographical distribution of EU OPT in footwear shifts illustrates the relative 'short-termism' of the strategies adopted in the sector.

Summing up, it appears that after having significantly contributed to CEE trade reorientation, OPT gives way to some form of protracted relations between foreign and local firms. This happens in different context: either because foreign partners keeps on with OPT, or because their transform OPT into foreign direct investment.

Thus, at least a first scenario where OPT would give way to very volatile and footloose relations is partially ruled out: OPT is not just a transient phenomenon embraced by Western firms to take advantage on a very short term basis of low wage levels. On this point, OPT in CEE differs from footloose off shore activities carried out in developing countries.

If local firms are more or less durably integrated into (associated with) the production chains of their foreign partners, the question remains open as to the terms under which co-operation takes place. Can local firms count on an upgrading process along the value added chain? Are they incited to link up with other local firms?

The above statistical evidence provides only very preliminary and imperfect responses. The generally (very) strong dynamism of direct trade suggests that local firms can seemingly do without OPT i.e., not only that they have an autonomous access to Western markets but also they do not need OPT to acquire input from abroad. In fact, the Hungarian case shows that, rather than testifying to the take over of OPT exports by local firms recovering their autonomy, the surge in direct trade might well be the result of the activities of foreign owned firms, i.e., former local OPT firms in which foreign partners took a share.

Similarly, the Hungarian case is only apparently the most favourable. Transformation of OPT into foreign direct investment is surely more likely to secure spill over, and technology transfers, and it is a good premise for upgrading the position of local firms in the VA of their foreign partners. But this is no sufficient condition, and cases where local firms are fully integrated but remain locked into low segment of value added cannot be ruled out.

By contrast, even though it is characterised by strong growth of direct trade, the Czech case is at first sight more worrying. As a matter of fact, the permanence of high levels of OPT indicates that the circular – captive - scheme is reproduced with negative impact on the development of backward linkages. But again, no equity participation can be in fact turned into local firms' advantage the latter playing the card of flexibility and competition among foreign partners. In short, more firm-level analysis is needed to lift the fundamental indeterminacy of trade statistics.

5. Inter-Firms OPT Relations and Market Linkages

This section tries to make sense of the variations identified in the preceding one and proposes different possible types of market linkages which they correspond to.

Table 4 classifies the trends observed in Section 4 into different categories.

Table 4

OPT and the evolution of direct trade: four scenarios.

	Very dynamic OPT increases	Slowing down of OPT increases / decreases
Dynamic direct trade increases	system suppliers / specialisation	foreign direct investment, classic take over / upgrading
Stagnant direct trade (or decrease)	maquiladora / captive	cross border workbench / footloose

- The right lower case presents the one scenario most in line with conventional theories of international trade (IT) and international production (IP). Firms are engaged in the OPT business only to take advantage of comparative advantage based on low labour costs. When (if) wage differentials are no longer advantageous, they withdraw from their commitment, helped in this by the very low exit costs associated with this form of IP. This might well correspond to the strategies of smaller firms which do not necessarily aim at the regionalisation of their activities, but simply at taking advantage of favourable labour costs in their immediate vicinity. Indeed, German firms, mainly Mittelstand (small and medium sized enterprises) use the OPT arrangement to undertake cross-border activities with the main objective of easing the constraint represented by high domestic labour costs (Kurz & Wittke 1997). This type of ‘workbench OPT’ is common in the footwear sector but, as shown above, in overall terms, it applies only to a minority of cases.[9]
- More interesting is the right upper case where a slowing down of OPT increases is apparently taken over by direct trade. It was suggested that, rather than

[9] Gerling and Schmidt found that firms based in the Baden Wuerttemberg region are only marginally engaged into cross-border activities in Poland (1997). The situation is likely to be different for Bavarian firms, for example, as the regions on the two sides of the Germano-Czech border are characterised by more differentiated historical and economic conditions and offer higher potentials for complementarity.

corresponding to truly independent exports this case illustrates the transformation of the nature of the OPT relation, which is no longer recorded statistically. In short, OPT is a first step before full vertical integration through foreign direct investment takes place. By the standard of established theories in IT/IP, this is the most favourable case. Characterised by a fundamentally transient dimension, OPT gives way to longer term partnerships with a higher level of commitment. Local firms cease being pendent on the sacrosanct will of their foreign partners and are more firmly associated in their production chains.

This is often the case in Hungary. One good example is given by the OPT partnership between Styl, a big producer of high quality garments in Szombathely (close to the Western border) and Baumler from Germany. Baumler who engaged OPT with Styl even before the fall of the COMECON, has acquired a majority share in Styl in order to secure the exclusivity of Styl's know how as Styl is indeed an OPT partner very much in demand (e.g. by Pierre Cardin of France).

- What is happening in the left lower case brings us back to an apparently more disadvantageous scenario for local firms. OPT is very dynamic and develops at the expense of direct untied trade.

  One interpretation is that this corresponds to the classic case of a maquiladora-like type of relations. Local firms are locked into the production chains of their foreign OPT partners, and they have no chance to access international markets independently nor to have their OPT partnership transformed. In short, they are integrated 'on the cheap'. In this case, prolonged OPT relationships can only be possible on the basis of wages that are kept low. However, this is in contrast with empirical evidence suggesting right the opposite: wages are often higher than in other non-OPT sectors.[10]

  There is an alternative explanation. It is interesting to note that this category comprises mostly OPT partnerships in the textile and clothing sector where the structure of trade protection consists of quantitative restrictions. This is important because quota are more constraining than tariffs: if they really want to access EU markets and if quota are filled, local firms have no other options than to look for an OPT partner so as to use the additional access opportunities available under the OPT regime. The fact that the incentive to resort to OPT is made all the more imperative gives foreign firms a very strong bargaining clout and enables them to extend control over their local partners without capital engagement. As a result, OPT yields the vertical 'quasi-integration' of partner-firms[11], and cumulates the advantages of equity investments and of contractual agreements (i.e., control, and flexibility, respectively) while minimising both their inconvenient (the cost of the

[10] What is more, the case is relatively frequent when wages *within a same company* are higher in the OPT workshop than in the rest of the firm. This is the case of Styl, for example.

[11] The terms was first coined by Houssiaux in 1957 to account for domestic sub-contracting activities. The notion has since then been developed to refer to non-equity forms of international production activities.

former, and the risk associated with the latter). In the end, binding quota substitute for the need of internalising inter-firm transactions.[12]

Thus, paradoxically, these cases resemble very much to the previous category where local firms are thoroughly integrated into the production chains of their partners. The difference is that it is vertical 'quasi'-integration rather than full integration that takes place.[13] One illustration of such vertical quasi-integration is given by the partnership between OP (Prostejov, Moravia in the Czech Republic) and Hugo Boss (Germany). The latter belongs to the Marzotto Group (Italy) which has indeed gone quite far in the rationalisation of its activities throughout the former countries of the CMEA. It carries out OPT with OP to produce men jackets and other sophisticated garments on a large scale and on a long term basis but without envisaging capital involvement.

- The most puzzling case is that of the right upper case where there is a *simultaneous* growth of OPT and direct trade: why foreign partners keep on carrying out OPT, admittedly a minor vehicle of IP, even though decreasing levels of protection are less of an incentive to do so ... and why local firms give way to the request of the latter if they apparently have autonomous access to Western markets? A plausible explanation is that local firms are in fact 'specialising' in the OPT job.

  The case of Vilati (Budapest) is illuminating in this respect. Vilati is a small company producing control systems, printed circuit boards and other electrical and electronic components. Although it has several OPT partners, Vilati has a privileged relation with Brunswick Bowling (US). It is integrated into the production chain of its main OPT partner in a rather flexible way, but it does not purport to recover independence, nor does it count on integrating its partner's production chain and upgrade its position within it. In fact, if Vilati is more loosely associated to its foreign partners than if it were fully integrated, this is not to say that its relations are more fragile, or unstable. Its strategy is indeed to establish its reputation as reliable and technologically updated supplier of component system to Original Equipment Manufacturers.

  In this case, OPT is used as a vehicle for implementing methods of production in line with the new requirements of international competition in terms of flexibility and quality. OPT goes together with the automatisation and the decomposition of the production process into stages which are more independent and 'de-integrated' from one another. OPT thus makes possible shorter delays and

[12] For an overview of the different theories explaining why firms internalise transactions in an international context, see Agarwal (1980), also Dunning (1998).

[13] There are two important factors facilitating the vertical quasi-integration of firms party to an OPT agreement. First, firms' size is an important intervening variable. Big local firms with large production capacities are more likely to come against quotas; they have more chance to be dependent on OPT, and are therefore more likely candidates for vertical quasi-integration. Another important condition is that local firms should have *one* privileged foreign partners occupying most of their production capacity.

quicker time delivery by applying Just in Time methods of production. In the end, the arrangement contributes to the formation of production chains which are less linear and more horizontal than traditionally organised. In brief, OPT fosters the development of 'system supplier' and gives way to more equal 'two-ways' relations between contractors and sub-contractors (Ernst et al. 1995).

There are two main reasons explaining why German firms are more likely to engage this sort of OPT partnerships with Czech rather than Hungarian partners. First, reduced distance acquires a renewed importance. As the cost component of competitiveness shrinks, the application of 'flexible' methods of production also reduces the share of variable labour costs in total costs. This means that the labour cost saving derived from relocation is also reduced. Thus geographical proximity - undertaking production activities in low-labour cost countries in the *immediate vicinity* of developed countries - takes on importance as it is a major condition to fulfill the requirements of flexibility [Oman 1994]. Of particular relevance is the fact that transport is organised by land (rather than by air or sea), giving to proximity an even higher premium (Zysman & Schwartz 1998: 420).

A second reason has to do with time variables, i.e., the chronological starting point of OPT relations which possibly influenced the time-horizon of German partners' strategies. Those who started their operations in Hungary under Communist times were acting in a environment particularly uncertain and were thus likely to be initially driven by relatively short-term strategic considerations. To subsequently warrant longer term commitment, they had to resort to traditional capital control. On the face of it, in the Czech Republic, more committed latecomers could contemplate longer-term strategies already at the start of OPT partnerships.

Explanatory variables have therefore to do with the beginning of the opening up process, and the distance between partner-firms engaged in OPT activities: time and space explain why system suppliers of German firms are more likely to develop in the Czech Republic, and why Hungarian firms are more likely to be integrated into vertical German production networks.

Overall, the OPT measure appears to promote the development of very different inter-firm relations which have different consequences for the probability of technology transfers and backward linkages. Beside traditional sub-contracting relations, the OPT measure also gives way to the development of system suppliers in the host economies. This rules out generalisations concerning the 'maquiladorisaton' of CEE, and/or CEE alleged structural dependency on Germany. It is also important to relativise the high expectations which are too often solely placed on equity links. Smaller firms can use the arrangement as a flexible vehicle to implement new production methods which bring about significant 'spill overs' to local economies. On the face of it, greenfield plants set up by big MNCs having at their disposal enough capital can afford to operate in comparatively more insulated 'enclaves'.

Interestingly enough, the above firm-level evidence suggests that the perpetuation of OPT relations without capital participation is not necessarily a bad thing for local firms. As a matter of fact, non-equity OPT links can be as – if not more – apt at applying new methods of production in line with a redefinition of international competition, than traditional forms of international production. In short, OPT is not synonymous with short-term offshore activities, nor full integration with upgrading and backward linkages.

Finally, it is worth stressing the permeability and the blurred character of the boundaries between the above OPT categories[14]. For example, even though quasi- and full-integration look very similar, they entail very different consequences for local firms depending on whether they comply with the new terms of international competition. Similarly, distinguishing between those partners engaging on very short term to exploit local assets and those promoting the formation of system suppliers is not an easy task. ... Local firms can switch from one category to another rather swiftly so that it makes little sense to classify single cases into too rigidly defined categories.

Overall, the range of the possibilities open to local firms is wide and continuous, and it is up to local firms to make the most of a measure which was originally designed to render them captive of their foreign partners.

6. Conclusion

The OPT example shows that trade arrangements still in place during the transition towards free trade[15] form an uneven playing field which firms in different sectors and from different countries are unequally apt at taking advantage. The paper identified three 'bias' introduced by policy makers through the OPT measure: the promotion of OPT at the expense of other vehicles of international production, the deprivation of local firms' market power, and the domination of the OPT business by German firms.

If they are representative of wider trends, these three features might rise serious concern about the terms under which economic interdependence develops between Central/Eastern Europe and the EU. Are CEE turning into an economic backyard to Germany? In fact, the paper dismisses fears concerning the excessive dependence of the CEE economies on OPT in general, and on German partners in particular.

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14 I owe this point to a discussion with B. Hancké.

15 For a discussion on the impact of another of such arrangement, rules of origin, see Lorentzen (1997).

Indeed, rather than considering OPT to be an instrument of the past promoting footloose off-shore activities or maquiladora to take advantage of favourable wage differentials, the paper showed that the arrangement can be used to implement new methods of production so as to weather the challenge of heightened global competition. The impact of different types of OPT strategies identified by the paper - the promotion of system suppliers, the consolidation of vertically integrated production chains, or the development of workbench activities and cross border transactions - are indications of the transformations that the European model of regional integration is undergoing in order to absorb the increased heterogeneity of its participating economies. The fact that these outcomes are mostly due to the relocation activities of German medium-sized firms illustrates the important role the latter have in bringing about such transformations.[16]

In the end, much depends on the differentiated uses firms of different sizes, from different sectors and of different countries make of the arrangement. Interestingly enough, these variations do not necessarily conform with the explicit intent of the EU policy-makers who devised the OPT measure. In other words, policy measures take their full significance at firm-level. Overall, OPT tells the story of how firms are *empowered* by policy-makers in the determination of the terms of East-West economic interdependence.

[16] This is an invitation to explore the reasons in their domestic economies which incited German firms to reconfigure their production organisation. For an application of this *problematique* to the automotive industry, see Hancké (1997).

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